

IN-HOUSE COUNSEL’S ROLE IN THE STRUCTURING OF MORTGAGE-BACKED SECURITIES

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We briefly introduce the financial crisis and the role played by mortgage-backed securities. Then we describe the controversy at issue: whether, in order to own and enforce the mortgage loans backing those securities, a special-purpose vehicle “purchasing” mortgage loans must take physical delivery of the notes and security instruments in the precise manner specified by the sale agreement. Focusing on this controversy, we analyze (i) the extent, if any, that the controversy has merit; (ii) whether in-house counsel should have anticipated the controversy; and (iii) what, if anything, in-house counsel could have done to avert or, after it arose, to mitigate the controversy. Finally, we examine how the foregoing analysis can help to inform the broader issue of how in-house counsel should address complex legal transactions.

Introduction	522
I. The 2008 Financial Crisis and the Role Played by MBS	522
II. The A-B-C-D Argument	523
III. Analysis.....	526
A. The Process of Transferring Mortgage Loans into SPVs ..	526
B. To What Extent, If Any, Does the A-B-C-D Argument Have Merit?	529
C. To What Extent, If Any, Should In-house Counsel Have Anticipated and Tried to Avert the Mortgage- Note Controversy?.....	530
D. What, If Anything, Could In-house Counsel Have Done to Mitigate the Mortgage-Note Controversy?.....	542
Conclusion.....	546

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INTRODUCTION

This Article examines how in-house counsel should address complex legal transactions by examining their role in the structuring of mortgage-backed securitization transactions. In that context, the Article also touches on the professional responsibility of in-house counsel in generally dealing with matters of legal risk. The Article begins by discussing mortgage-backed securities in the context of the recent financial crisis.

I. THE 2008 FINANCIAL CRISIS AND THE ROLE PLAYED BY MBS

The 2008 financial crisis is closely tied to the securitization of subprime, or risky, residential mortgage loans.¹ Securitization refers to a category of financing transactions in which lenders sell rights to payment under mortgage loans, accounts receivable, lease rentals, and other types of income-producing “financial assets” to a trust or other special-purpose vehicle (an “SPV,” sometimes interchangeably called a special-purpose entity or SPE). The goal is to separate the financial assets from the risks generally associated with the original lender—usually called the “originator” to distinguish it from the SPV. The SPV issues securities (usually called mortgage-backed securities, or “MBS,” when the SPV’s financial assets consist of mortgage loans) to capital market investors, using the proceeds to pay the purchase price of the financial assets. This funds the originator at a lower cost than if it had borrowed the money from a bank or other financial intermediary.²

Prior to the financial crisis, securitization transactions were sometimes backed, at least in part, by subprime residential mortgage loans. Because home prices had generally been increasing in the United States since the Great Depression, the expectation was that continuing home-price appreciation would enable even risky borrowers to repay their loans by refinancing their houses. But this model failed when, in 2007 and 2008, home prices fell significantly. Subprime borrowers, who were relying on refinancing for loan repayment, could not refinance. Furthermore, many subprime mortgage loans had adjustable

1. A mortgage loan is a right to payment evidenced by a promissory note signed by the borrower, where the note is secured by the lien of a mortgage. BLACK’S LAW DICTIONARY 1020 (9th ed. 2009). The term “mortgage” is used in this Article to include any security interest in real property supporting the note, including deeds of trust and deeds to secure debt in addition to mortgages.

2. STEVEN L. SCHWARCZ, STRUCTURED FINANCE: A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION §§ 1:1, 1:3 (Adam D. Ford ed., 3d ed. 2010). Investors in the securities expect to ultimately be paid from collections on those financial assets.

rates that increased after an initial “teaser” period. Borrowers who could not afford the rate increases had expected to refinance at lower interest rates. That likewise was stymied by collapsing home prices. For these reasons, risky borrowers began defaulting, ultimately impairing payment on the securities. Investors started losing confidence, and the price of MBS plummeted. With the collapse of Lehman Brothers, the loss of confidence extended beyond MBS, causing a broader debt crisis and impacting the real economy.³

II. THE A-B-C-D ARGUMENT

It has been repeatedly argued in financial and consumer blogs, at seminars, and, recently, in the mainstream press that residential mortgage-backed securities may be “non-mortgage-backed” securities due to failure to comply with contractual requirements of sale.⁴ According to these arguments, the law requires that the SPV purchasing the mortgage loans⁵ not only must have a signed contract of sale for those loans but also must take physical delivery of the promissory notes evidencing those loans (hereinafter, “notes”) in the precise manner

3. See Steven L. Schwarcz, *Understanding the Subprime Financial Crisis*, 60 S.C. L. REV. 549, 550–53 (2009).

4. See, e.g., Linda Beale, *The Mortgage Loan Foreclosure Mess: Yves Smith on the Banks' Gluttony; Problems with MERS and Sloppy Securitizations*, ATAXINGMATTER (Nov. 1, 2010), <http://ataxingmatter.blogs.com/tax/2010/11/yves-smith-on-the-banks-gluttony.html>; Adam Levitin, *The Big Fail*, CREDIT SLIPS (Nov. 22, 2010, 2:50 PM), <http://www.creditslips.org/creditslips/2010/11/securitization-fail.html>; Yves Smith, Op-Ed, *How the Banks Put the Economy Underwater*, N.Y. TIMES (Oct. 30, 2010), <http://www.nytimes.com/2010/10/31/opinion/31smith.html>. One argument often advanced is that such transfers also fail to comply with legal requirements of sale, as most of the terms of the UCC may be modified by agreement of the parties. See U.C.C. § 1-302 (2001); see also N.Y. U.C.C. LAW § 1-205 (McKinney 2001). But this simply makes the UCC equivalent to the parties' contract (the sale agreement) and is therefore equivalent to failure to comply with contractual requirements. See *infra* note 27 and accompanying text.

N.B.: While Article 9 of the UCC is indeed uniform in relevant part, the other articles (in particular, Articles 1 and 3) vary among states. For example, New York's version of the UCC does not contain § 1-302, and its version of Article 3 dates back to the 1950s. N.Y. U.C.C. LAW (McKinney 2001). As most of the sales agreements used in securitizations are governed by New York law, this distinction may be important, though we believe that subsequent revisions of the UCC probably often reflect rather than change pre-existing common law and therefore may be good common law in New York. Our citations to the UCC itself are to the current version published by the National Conference of Commissioners on Uniform State Laws; references to individual states' versions are cited as such.

5. This Article does not address the extent, if any, to which that argument might apply to other types of financial assets.

specified by the sale agreement.⁶ As the result of the multiple sales agreements involved in a typical mortgage securitization, in which the loans are typically sold by A to B, by B to C, and by C to D (where A is the originator, D the SPV, and B and C intervening parties), this is often called the “A-B-C-D” or alphabet argument.⁷ We adopt that terminology in this Article.

If physical delivery of the notes were not taken in exactly the manner specified by the sale agreement, advocates of the A-B-C-D argument contend that the SPV would not own and therefore could not enforce the mortgage loans.⁸ The mortgage loans would then revert to the originator, which would then have an obligation to refund the

6. This Article does not address the scenario where, as often, the SPV is a New York trust. In that scenario, some argue that the SPV must also take physical delivery of the notes and security instruments, even if physical delivery is not required by the contract or applicable law (other than New York trust law). New York trust law is based, however, on gratuitous trusts (i.e., the law of gifts), which requires delivery of the gift because there is no consideration. Therefore, logically, this requirement of New York trust law should not apply to a commercial trust such as an SPV. *See* N.Y. C.P.L.R. § 7-1.18 (Mckinney 2011) (providing that transfers to a lifetime trust are “not accomplished by recital of assignment, holding or receipt in the trust instrument”); N.Y. C.P.L.R. § 1-2.20 (Mckinney 2011) (excluding business and investment trusts from the definition of “lifetime trust”); *see also* N. Wooten, 2010 11 12 Memo on NY Trust Law and Delivery Issues (Nov. 12, 2010) (unpublished) (on file with author) (citing only cases involving gifts and transfers without consideration in support of the proposition that physical delivery is required to complete the transfer of notes and mortgages to a New York trust while acknowledging that assignment may constitute delivery).

7. There is an ancillary argument to the A-B-C-D argument: that not only the notes but also the mortgages securing the notes must be transferred. This ancillary argument is much weaker than the A-B-C-D argument because, in most (if not all) states, it is clear that collateral follows the debt it secures. *See, e.g., Carpenter v. Longan*, 83 U.S. 271, 274 (1872) (“The note and mortgage are inseparable An assignment of the note carries the mortgage with it, while an assignment of the latter alone is a nullity.”). The UCC codified this common law rule. U.C.C. § 9-203(g) (1998) (“The attachment of a security interest in a right to payment . . . secured by a . . . lien on . . . real property is also attachment of a security interest in the . . . mortgage, or other lien.”); *see also* PERMANENT EDITORIAL BD. FOR THE UNIF. COMMERCIAL CODE, APPLICATION OF THE UNIFORM COMMERCIAL CODE TO SELECTED ISSUES RELATING TO MORTGAGE NOTES 12 (2011), *available at* http://www.uniformlaws.org/Shared/Committees_Materials/PEBUCC/PEB_Report_111311.pdf (confirming same). Our Article will therefore focus solely on the A-B-C-D argument.

8. *Problems in Mortgage Servicing from Modification to Foreclosure: Hearing Before the S. Comm. on Banking, Hous. & Urban Affairs*, 111th Cong. 19 (2010) (statement of Adam J. Levitin, Associate Professor, Georgetown University Law Center) [hereinafter Levitin Statement]. This might be viewed as a type of transactional law failure (i.e., a failure to comply with law or contract in connection with a business transaction, as compared, for example, to other types of failures such as accounting failures, *ultra vires*-type failures, and violation-of-law failures).

purchase price paid by the MBS investors, plus interest, less any distributions on the mortgage loans.⁹

Such a reversion would create chaos. It would be difficult if not impossible to calculate and allocate the refund payments, and few originators would have the wherewithal to pay such refunds. Indeed, many if not most originators of subprime mortgage loans are now insolvent or close to insolvency.¹⁰ In cases where the originator no longer exists and its obligations have not been assumed by a successor, ownership of the mortgage loans would become unclear, clouding title not only to those loans but also possibly to the underlying property.

Such a failure to transfer the mortgage loans to the SPV would also create serious tax issues, even if they were subsequently transferred in accordance with the A-B-C-D argument to cure the ownership issue. The SPV would not qualify for the entity-level tax exemption as a real estate mortgage investment conduit (REMIC) if it failed to gain ownership of the mortgage loans at or within ninety days of closing.¹¹ Absent another exemption from taxation, the SPV would then be subject to an entity-level tax, which would reduce net payments to investors in its securities. In the case of transfers of mortgage loans more than ninety days after closing, there would be a tax of one hundred percent of the value of the transferred assets.¹²

In a related but distinct argument, even if the SPV (or its agent, such as a servicer) owned and had possession of the notes, proponents of the A-B-C-D argument contend that the SPV could not enforce the mortgage loans unless the notes were indorsed in the precise manner specified by the sale agreement. Their rationale is that notes that are not indorsed in accordance with the sale agreement should be presumed to

9. *Id.* at 20.

10. Worth Civilis & Mark Gongloff, *Subprime Shakeout: Lenders that Have Closed Shop, Been Acquired or Stopped Loans*, WALL ST. J. ONLINE, <http://online.wsj.com/public/resources/documents/info-subprimeloans0706-sort.html#top> (last visited Nov. 2, 2011).

11. See Scot J. Paltrow, *IRS Weighs Tax Penalties on Mortgage Securities*, REUTERS (Apr. 27, 2011), <http://www.reuters.com/article/2011/04/27/us-usa-mbs-taxes-idUSTRE73Q7UX20110427> (discussing potential REMIC violations and contrasting the views of James Peaslee and Adam Levitin on whether the Internal Revenue Service will pursue enforcement of alleged REMIC violations).

12. *Id.* The A-B-C-D argument maintains that the mortgage loans have not been transferred and, apparently alternatively, that the notes (rather than the mortgage loans) are the actual assets and therefore cannot be delivered more than ninety days after closing; that would render the SPV unable to cure its ineligibility for REMIC treatment (and, indeed, its lack of ownership of any assets). See Adam J. Levitin & Tara Twomey, *Mortgage Servicing*, 28 YALE J. ON REG. 1, 14 n.35 (2011).

be fraudulent.¹³ Moreover, if the notes are indorsed to a servicer or other collection agent rather than to the SPV, proponents of the A-B-C-D argument contend that the indorsee is not a real party in interest and therefore should not be able to enforce the notes. We view this as an evidentiary issue based on the procedures that were (or were not) followed in transferring an individual loan, rather than a structural argument that the SPV does not own the mortgage loans at all. As such, this evidentiary issue may well have merit in particular cases.¹⁴

In this Article, we first analyze the merits of the A-B-C-D argument. We then analyze whether in-house counsel of clients that structure or invest in mortgage-securitization transactions should have anticipated the controversy spurred by that argument. Thereafter, we analyze what, if anything, in-house counsel could have done to avert—or, after it arose, to mitigate—the controversy. Finally, we examine how the foregoing analyses can help inform the broader issue of how in-house counsel should address complex legal transactions.

III. ANALYSIS

A. The Process of Transferring Mortgage Loans into SPVs

To understand the merits of the A-B-C-D argument, one needs to first understand the process by which mortgage loans are transferred to SPVs. In securitization transactions, the transfer occurs pursuant to contracts variously known as pooling and servicing agreements (usually referred to as PSAs), sale and servicing agreements, mortgage loan purchase agreements, and the like. Because the contract (following standard legal definitions) defines the mortgage loan to include the note

13. See, e.g., Yves Smith, *4ClosureFraud Posts Lender Processing Services Mortgage Document Fabrication Price Sheet*, NAKED CAPITALISM (Oct. 3, 2010, 12:01 AM), <http://www.nakedcapitalism.com/2010/10/4closurefraud-posts-docx-mortgage-document-fabrication-price-sheet.html> (suggesting that the failure to establish proper chains of endorsement led some financial firms to turn to forgeries and other fraudulent methods to establish their right to foreclose on mortgages).

14. See, e.g., *Kemp v. Countrywide Home Loans, Inc. (In re Kemp)*, 440 B.R. 624, 628–29 (Bankr. D. N.J. 2010), (finding that the debtor's note was never transferred from Countrywide to Bank of New York, which had filed a proof of claim against the debtor for the note); *U.S. Nat'l Bank Ass'n v. Ibanez*, No. SJC 10694 (Mass. Jan. 7, 2011); *Deutsche Bank Nat'l Trust Co. v. Francis*, No. 50423(U), slip op. (N.Y. Sup. Ct. Mar. 25, 2011) (dismissing foreclosure action with prejudice because plaintiff could not demonstrate that it owned the mortgage and note when it initiated the foreclosure action).

and the mortgage, the sale of the mortgage loan includes the sale of the note and the mortgage.¹⁵

The A-B-C-D argument pertains primarily to mortgage-securitization transactions entered into since 2001. Uniformly effective July 1, 2001, Article 9 of the Uniform Commercial Code (UCC) was amended to govern the sale of promissory notes¹⁶ and to provide that their sale—which would include the sale of any collateral (such as mortgages) securing the notes¹⁷—could be effected merely by the seller signing a sale agreement describing the notes, without indorsement or delivery of the notes.¹⁸ The buyer would then automatically be protected from most third-party claims.¹⁹

Nonetheless, because promissory notes traditionally have been (and under the amended Article 9 continue to be)²⁰ transferred by being indorsed and physically delivered (and indeed Article 9 provides that the rights of subsequent transferees of notes can sometimes trump the rights of owners of the notes who do not actually hold them directly or through an agent),²¹ parties to these contracts were concerned that the SPV's rights to the notes might become subordinate to the rights of third parties who, for whatever reason, actually receive the indorsed notes. In order to protect the SPV and its MBS investors, the contracts

15. This is achieved through a sentence known as the Granting Clause, which generally states that the originator sells, transfers, assigns, grants, and conveys to the buyer all its right, title, and interest in and to the mortgage loans.

16. U.C.C. § 9-109(a)(3) (1998). Under this amendment, which was officially proposed in 1998, the UCC also governs the sale of payment intangibles such as the mortgage loans in the same manner as promissory notes. Although this both clarifies and incorporates into law the longstanding practice of selling mortgage loans by contract, we do not address this provision in our Article because the A-B-C-D argument and the mortgage-note controversy consider only the notes. N.B.: Article 9 has subsequently been revised, but those revisions have not been adopted by all relevant jurisdictions, whereas the 1998 amendment has been enacted by all fifty states, the District of Columbia, Puerto Rico, and the U.S. Virgin Islands. Our citations refer to the 1998 amendment that became effective in 2001 rather than the subsequent revisions proposed by the National Conference of Commissioners on Uniform State Laws.

17. See U.C.C. § 9-109 cmt. 7 (1998).

18. § 9-203(b)(3)(A).

19. See § 9-309(4) (providing that a sale of a promissory note is automatically perfected); *cf. infra* notes 20-21 and accompanying text (discussing third-party claims of certain purchasers).

20. See § 9-203(b)(3)(B).

21. Promissory notes are “instruments” under Article 9 and as such may be “transferred by delivery with any necessary indorsement or assignment.” § 9-102(47); § 9-102(65) (defining a promissory note as an instrument). The sale of promissory notes is also governed by § 9-109(a)(3). The rights of purchasers of promissory notes who do not (directly or through an agent) take possession of the notes are subordinate, however, to the rights of a purchaser of the notes who gives value and takes possession of the notes in good faith and without notice of the prior ownership. § 9-330(d).

therefore generally provided for delivery and indorsement of the notes to the SPV or its agent. To this end, a typical contract would require that “in connection with the sale,” the notes be delivered to the SPV (or its agent, the document custodian), indorsed or assigned as specified by the contracts. We will call this requirement the “delivery instructions.”

The delivery instructions also were intended to enable the SPV or its agent to actually enforce the notes, where appropriate. State law generally requires that any person seeking to enforce a promissory note—and, by extension, foreclose on a mortgage securing the note—must have physical possession of the note.²² As before, the delivery instructions continue to safeguard the SPV’s interests.

Unfortunately, over the years procedural standards in mortgage securitizations appear to have deteriorated along with loan-underwriting standards. As a result, in some, if not many or most, cases, notes were neither indorsed nor delivered to the SPV or its agent in accordance with the delivery instructions.²³ Moreover, it appears that mortgage loan servicers seeking to enforce notes on behalf of the SPV did not always bother to take physical possession of the notes in accordance with state law.²⁴

As home foreclosures skyrocketed, the consumer bar learned about securitization of mortgage loans. They located securitization sales agreements and parsed their provisions, reading the delivery instructions as necessary to—rather than merely protective of—the sale of the mortgage loans to the SPV (in other words, creating a conditional rather than absolute sale of those loans).²⁵ To this end, they

22. See U.C.C. § 3-301 (1990) (specifying person entitled to enforce an instrument); U.C.C. § 1-201(b)(21) (2001) (defining “holder” as person in possession of an instrument).

23. See, e.g., Kathleen M. Howley, *Foreclosure Errors Cloud Homeownership with ‘Blighted Titles’*, BLOOMBERG (Oct. 1, 2010, 5:35 PM), <http://www.bloomberg.com/news/2010-10-01/foreclosure-errors-cloud-homeownership-with-millions-of-blighted-titles-.html>.

24. See *infra* note 77. Some mortgage servicers appear simply to have printed photocopies of the note. Kate Berry, *Robo-Signing Redux: Servicers Still Fabricating Foreclosure Documents*, AM. BANKER (Aug. 31, 2011, 5:47 PM), http://www.americanbanker.com/issues/176_170/robo-signing-foreclosure-mortgage-assignments-1041741-1.html?zkPrintable=1&nopagination=1. Indorsement or assignment of those copies with the intent to enforce is now known as “robo-signing,” a type of fraud. See *id.*

25. See, e.g., *Correia v. Deutsche Bank Nat’l Trust Co.*, 452 B.R. 319, 321 (B.A.P. 1st Cir. 2011) (“[T]he Debtors filed a complaint against Deutsche Bank (and IndyMac) to set aside the foreclosure sale [of their home]. They alleged that the purported assignments [of the mortgage] from IndyMac to Deutsche Bank were flawed because they did not comply with the terms of the PSA. According to the Debtors, this rendered them invalid.”); *In re Samuels*, 415 B.R. 8, 14 (Bankr. D. Mass. 2009) (“[T]he Debtor contends that the PSA required that all mortgages acquired thereunder

argued (among other things) that because the UCC may be varied by agreement,²⁶ the delivery instructions actually modified the UCC to require that the notes must be indorsed and timely delivered to the SPV or its agent in order for their sale to be effective and in order for the SPV to have standing to enforce the notes.²⁷

B. To What Extent, If Any, Does the A-B-C-D Argument Have Merit?

We believe that the A-B-C-D argument has little or no legal merit with respect to the structure of mortgage securitizations. Under contract law, the question is whether delivery instructions providing that, “in connection with the sale,” the notes must be delivered to the SPV or its agent indorsed as specified by the securitization contract requires such delivery and indorsement in order for the sale to become effective. The delivery instructions are not described as conditions to closing the securitization transaction or to the sales thereunder, nor are escrows or hold-backs established pending proof of satisfaction of the instructions.²⁸ Rather, those instructions appear to be intended to protect the SPV and its investors, not to invalidate their rights if the instructions were not complied with.²⁹

We have already explained how commercial law, which is governed by the UCC, enables the sale of the mortgage loans without delivery and indorsement of the notes. The only remaining question—

had to be funneled to Deutsche Bank, as pool trustee, through the entity designated by the PSA as ‘depositor,’ ARSI. A failure to follow this protocol . . . would, the Debtor contends, constitute a breach of the PSA”); *c.f.* Adam Levitin, *Standing to Invoke PSAs as a Foreclosure Defense*, CREDIT SLIPS (Aug. 4, 2011, 7:05 PM), <http://www.creditslips.org/creditslips/2011/07/standing-to-challenge-standing.html> (“Adherence to the PSA determines whether there was a transfer effected or not because under NY trust law (which governs most PSAs), a transfer not in compliance with a trust’s documents is void.” (emphasis omitted)).

26. The UCC states that, with certain limitations, “the effect of provisions of [the Uniform Commercial Code] may be varied by agreement.” U.C.C. § 1-302(a) (2001).

27. Levitin Statement, *supra* note 8, at 12. They also argued that any notes indorsed in a manner that did not conform to the sales agreements were presumptively invalid. *Cf.* Adam Levitin, *Do We Have a Fraud Problem? The Case of the Mysteriously Appearing Allonge*, CREDIT SLIPS (Jun. 16, 2011, 8:43 PM), <http://www.creditslips.org/creditslips/2011/06/do-we-have-a-fraud-problem-the-case-of-the-mysteriously-appearing-allonge.html>.

28. *See, e.g.*, Adjustable Rate Mortgage Trust 2006-2, Current Report (Form 8-K) Ex. 10.1: PSA § 2.01 (May 12, 2006) (exemplifying common PSA terms for the conveyance of mortgage notes). The delivery instructions still have independent force, however, because their breach would enable the SPV to sue under the contractual remedies for breach.

29. *See supra* notes 21-22 and accompanying text.

whether the delivery instructions modified the UCC to require such indorsement and delivery—is effectively one of contract interpretation, which has already been answered.³⁰

We next examine whether in-house counsel of clients structuring or investing in mortgage-securitization transactions should have anticipated and tried to avert the controversy over the A-B-C-D argument—which for simplicity we will hereinafter refer to as the “mortgage-note controversy.”

C. To What Extent, If Any, Should In-house Counsel Have Anticipated and Tried to Avert the Mortgage-Note Controversy?

Observers generally recognize that in-house counsel are particularly well situated to serve an anticipatory and preventive function for their business clients.³¹ In contrast to outside counsel, who typically are too costly to involve in the early stages of a transaction or legal issue, in-house counsel are almost always present and can offer legal advice early in the decision-making process.³² Also, because in-

30. See *supra* text accompanying notes 28-29.

31. E.g., JOHN C. COFFEE JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 195 (2006) (“[T]he inside counsel is uniquely positioned to specialize in preventive law.”); Abram Chayes & Antonia H. Chayes, *Corporate Counsel and the Elite Law Firm*, 37 STAN. L. REV. 277, 281 (1985) (“The general counsel, as a part of senior management . . . has both the right and responsibility to insist upon early legal involvement in major transactions that will raise significant legal issues.”); Richard S. Gruner, *General Counsel in an Era of Compliance Programs and Corporate Self-Policing*, 46 EMORY L.J. 1113, 1116 (1997) (“[T]oday’s general counsel is much more concerned with forward-looking, systematic features of corporate law compliance.”); Robert Eli Rosen, *The Inside Counsel Movement, Professional Judgment and Organizational Representation*, 64 IND. L.J. 479, 519 (1989) (“As in the management of outside counsel, in preventive law practice, corporations rely on inside counsel to implement and determine corporate interests.”); Omari Scott Simmons & James D. Dinnage, *Innkeepers: A Unifying Theory of the In-House Counsel Role*, 41 SETON HALL L. REV. 77, 115 (2011) (explaining that in-house counsel possesses traits “essential to practicing strategic preventive law”). Several significant judicial opinions also suggest, without explicitly recognizing, a special preventive role for in-house counsel. While considering the extent of attorney-client privilege in the corporate context, the U.S. Supreme Court explained that the privilege exists to “encourage full and frank communication between attorneys and their clients and thereby promote broader public interests in the observance of law and administration of justice.” *Upjohn Co. v. United States*, 449 U.S. 383, 389 (1981). Additionally, in 2009 Delaware’s high court explicitly held that corporate officers, including general counsel, owe fiduciary duties to their corporation. *Gantler v. Stephens*, 965 A.2d 695, 708–09 (Del. 2009).

32. Chayes & Chayes, *supra* note 31, at 280; Simmons & Dinnage, *supra* note 31, at 115. In companies with small in-house legal departments, however, transactional work may be outsourced to outside counsel even in the early stages of a transaction or legal issue. That would limit in-house counsel’s oversight role. Email from Gabe Shawn Vargas to Steven L. Schwarcz (Jan. 30, 2012) [hereinafter Vargas Email] (Gabe

house counsel only serve a single client,³³ they benefit from superior information about that client's organization, operations, and business culture.³⁴ This information is also "dynamic" in the sense that, at any given time, in-house lawyers know whom in their company to contact about an issue as well as the status of ongoing projects.³⁵ Furthermore, their knowledge of the law equips in-house counsel to educate corporate employees about potential legal issues and avoid costly compliance problems.³⁶

A crucial qualifier must be added to the informational superiority of in-house counsel: the information they receive from corporate management is heavily dependent on the nature of their relationship with such management. Lawyers who question business decisions too often, or who seem overly cautious, risk being perceived as obstacles to deal-making and are liable to be frozen out of information channels within the organization.³⁷ Thus, the theoretical information advantage of an in-house lawyer can be constrained by the lawyer's ability to forge relationships within the company and even by the vicissitudes of office politics.³⁸ To be most effective, in-house counsel need to be—and to be seen by their clients as—members of the corporate "team": working towards the same goals, even when their role on the "team" seems to be in conflict with a business group's particular wishes.

In-house counsel are also well-situated to guard the long-term interests of the company against the possibly short-sighted behavior of management. The interests of line personnel are not inherently opposed to the long-term interests of their company; indeed, their interests are obviously linked in many fundamental ways. However, compensation

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33. Albeit a complex client, generally speaking. Simmons & Dinnage, *supra* note 31, at 111–12.

34. *Id.* at 113–14.

35. *Id.* at 114.

36. Chayes & Chayes, *supra* note 31, at 284; Gruner, *supra* note 31, at 1157–58. In-house counsel's knowledge of both the law and their client-employer's business offers them a "dual competency," magnifying the value of their advice and education efforts. Simmons & Dinnage, *supra* note 31, at 114, 117–18.

37. See, e.g., Robert L. Nelson & Laura Beth Nielsen, *Cops, Counsel, and Entrepreneurs: Constructing the Role of Inside Counsel in Large Corporations*, 34 LAW & SOC'Y REV. 457, 471 (2000).

38. See *infra* note 52 and accompanying text. This type of tension is one of the reasons for the emergence of dedicated compliance departments in many companies. Varges Email, *supra* note 32. On the emergence of compliance functions generally, see Gabe Shawn Varges, *The Compliance Side of International Legal Practice*, in CAREERS IN INTERNATIONAL LAW 6, 6–8 (2003–04) [hereinafter Vargus, *Compliance Side*]; Gabe Shawn Varges, *Emerging International Indicators for Compliance Function Expectations*, LexisNexis, 2010 Emerging Issues 4906 (Mar. 2010), at 2–3.

structures that reward accomplishing short-term goals, like the successful negotiation of a deal or the execution of an asset transfer, can create perverse incentives for managers.³⁹ In-house counsel, however, are not subject to the same incentives as managers because their compensation is typically not linked to transactional volume or quantitative performance measures. To that extent, they serve as a counterweight to managers, guarding against short-term myopia as part of their preventive role.⁴⁰

External factors also make the anticipatory and preventive functions of in-house counsel increasingly important. The increasing scope and complexity of business regulation necessitates vigilance by in-house counsel to guide corporate management through a forest of legal regimes and regulations.⁴¹ In-house counsel are also increasingly conscious of the reputational harm their companies can suffer as a result of legal problems.⁴²

As our analysis next shows, if in-house counsel serve special anticipatory and preventive functions within their clients,⁴³ they

39. Steven L. Schwarcz, *Conflicts and Financial Collapse: The Problem of Secondary-Management Agency Costs*, 26 YALE J. ON REG. 457, 460 (2009). For example, financial firms using the value-at-risk model offered bonuses to secondary managers whose transactions were profitable and low in risk. *Id.* This incentivized some managers to offset risk with credit default swaps and other hedging devices with low probabilities of failure, but high costs in the event of default. *Id.*

40. Varges observes that in-house counsel sometimes are still rewarded based in part on the completion of transactions. Varges E-mail, *supra* note 32. He also observes, in arguing for better internal company oversight of compensation systems, that “[o]ne of the most striking features of the recent financial crisis was the near total absence of evidence of control functions playing a material role in their companies’ remuneration systems.” Gabe Shawn Varges, *Governing Remuneration*, in SCHWEIZERISCHER BANKRECHTSTAGUNG 2011: CORPORATE GOVERNANCE 49, 72 (Susan Emmenegger ed., 2011), available at http://www.ibr.unibe.ch/unibe/rechtswissenschaft/ibr/content/e8891/e8893/e10096/files10105/GBT11_TB_Inhalt_definitiv_rk.pdf.

41. Chayes & Chayes, *supra* note 31, at 284; Simmons & Dinnage, *supra* note 31, at 99–106.

42. See Gruner, *supra* note 31, at 1119.

43. At least one prominent observer strongly argues that in-house counsel should do their best to forecast legal trends and incorporate those trends into a client company’s strategic business planning:

[T]he corporate counsel must be a futurist, a seer. Counsel must use his legal foresight to discern trends in the law and to predict how those trends will impact the company’s business over time. Understanding legal trends, however, is not enough; the lawyer must also understand business dynamics and societal demographics. . . . The forward-looking corporate counsel who identifies trends, evaluates the likelihood of occurrence, devises legal solutions to probable changes, and alerts management to the changes for purposes of devising business strategies in response to them will make a key

certainly should have tried, at least as an aspirational goal, to alert their clients to the mortgage-note controversy and its potential reputational and litigation costs—assuming they were able to foresee the controversy.⁴⁴ First, however, we should consider whether in-house counsel had any obligations under existing professional standards.

Under those standards, lawyers, including in-house counsel, are expected to render “competent” services with the “legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation.”⁴⁵ They can fulfill this duty by advising their client in good faith after making reasonable efforts to research a given issue.⁴⁶ But the duty to be proactive, according to the ABA’s *Model Rules of Professional Conduct*, is generally limited to actions needed to prevent harmful violations of legal obligations to the client or violations of the law:

contribution to the future economic health and well-being of a business entity.

Carl D. Liggio, *The Changing Role of Corporate Counsel*, 46 EMORY L.J. 1201, 1208–09 (1997). Although in-house counsel’s unique informational and organizational locus offers opportunities to proactively manage a client’s legal problems, it also presents unique conflicts that call into question the extent to which in-house counsel should embrace preventive law practice. See Deborah A. DeMott, *The Discrete Roles of General Counsel*, 74 FORDHAM L. REV. 955, 965–66 (2005). Exposure to information “back-channel[s]” not available to outside counsel could put in-house counsel in a position “that may require uncomfortable choices.” *Id.* at 966 (quoting Geoffrey C. Hazard, Jr., *Ethical Dilemmas of Corporate Counsel*, 46 EMORY L.J. 1011, 1018 (1997) (using the term “water cooler” to describe spaces where “back-channel information, office gossip, rumors and portents of future corporate undertakings” may be exchanged)). Moreover, attorneys that implement and oversee compliance programs at a company may be faced with an ethical challenge when called upon to defend corporate actions in their role as advocates. *Id.* at 965–66. Sung Hui Kim draws extensively on psychological research to explain that in-house counsel’s employee status, professional role as an agent of the corporation, and desire to be team-players may explain their apparent inability or unwillingness to prevent corporate fraud. Sung Hui Kim, *The Banality of Fraud: Re-situating the Inside Counsel as Gatekeeper*, 74 FORDHAM L. REV. 983, 1001–34 (2005). These observers raise some troubling questions about the ability of in-house counsel to effectively fulfill a preventive role, but their inquiries are chiefly directed at preventing corporate malfeasance and fraud. Because their unique position specially equips in-house counsel to act preventively, at the very least with respect to mundane legal risks, they should attempt to offer anticipatory guidance to their employees with a healthy understanding of their limits as “seers.”

44. See *infra* notes 73–78 and accompanying text (examining whether in-house counsel should have been able to foresee the mortgage-note controversy).

45. MODEL RULES OF PROF’L CONDUCT R. 1.1 (2002); see also 7 AM. JUR. 2D *Attorneys at Law* § 203 (2007).

46. See 7 AM. JUR. 2D *Attorneys at Law* § 203 (2007).

If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law that reasonably might be imputed to the organization, and that is likely to result in substantial injury to the organization, then the lawyer shall proceed as is reasonably necessary in the best interest of the organization. Unless the lawyer reasonably believes that it is not necessary in the best interest of the organization to do so, the lawyer shall refer the matter to higher authority in the organization . . .⁴⁷

In-house counsel considering the need for physical delivery and indorsement of mortgage notes in securitization transactions could well have determined in good faith that the delivery instructions were intended to be protective and thus did not, at least *per se*, cause any harmful violations of legal obligations to the client or any violations of the law.⁴⁸ And even if in-house counsel determined that a legal obligation might have been violated, the ability to cure makes it uncertain that a violation would be “likely to result in substantial injury” to the client.⁴⁹ Thus, under existing professional standards, it appears that in-house counsel were not obligated to alert their clients to the mortgage-note controversy and its potential reputational and litigation costs.⁵⁰

47. MODEL RULES OF PROF'L CONDUCT R. 1.13(b) (2011).

48. *See supra* Part III.A.

49. *See* MODEL RULES OF PROF'L CONDUCT R. 1.13(b) (2011). Because failure to deliver the notes to the SPV could jeopardize the ability of that entity to enforce the notes if a third-party gained possession of the instruments, in-house counsel to clients who *invest* in MBS likely had a duty to advise clients on the significance of the delivery instructions and indorsements. However, beyond rendering such advice, the lawyers' responsibilities would be limited both formally by the scope of the rules and practically by their limited ability to monitor third-parties to a transaction. Indeed, on the investor side of such transactions, in-house counsel's organizational and informational advantages are effectively negated because the compliance obligations rest with other parties to the transaction or even third-parties.

50. Vargès observes that these existing professional standards, which he refers to as the “advisory model of lawyering,” are generally consistent with professional standards internationally. Vargès E-Mail, *supra* note 32. Furthermore, although the advisory model serves companies well for the provision of normal in-house legal services, Vargès argues that it is less apt for a more preventive role. *Id.* He advocates for companies using compliance officers who can operate beyond this model to engage in more preventive activities and who are better positioned to challenge management on matters that, although legal, may be inconsistent with the company's values or represent

If in-house counsel learned that delivery instructions were not being complied with, they nonetheless might have wished to bring that lapse to the attention of their corporate client. The extent to which they should urge the client to comply would be a matter of judgment, however, balancing the legal risk from non-compliance (which would, as discussed, have appeared remote before the crisis) against the potential to be perceived as obstructing transactions and imposing needless expense.⁵¹ Lawyers faced with this balancing should try to avoid achieving a Pyrrhic victory—ensuring compliance with the delivery instructions but undercutting their authority to tackle future issues by eroding management’s trust in their judgment and performance.⁵²

Some observers suggest that corporate attorneys, including in-house counsel, should also adhere to a higher standard of care commensurate with their specialized technical knowledge and ability to forestall legal problems, and that such duty should extend to the public—including public financial markets. Professor John Coffee, for instance, argues that in-house counsel and other corporate attorneys should act as “gatekeepers” in some circumstances,⁵³ using their critical position within an organization to prevent wrong-doing and serving as “reputational intermediar[ies],” offering markets tacit information about the quality of a corporation or its securities.⁵⁴ In this role, corporate lawyers would benefit not only their client, but also third-

a reputational risk. *See generally* Vargas, *Compliance Side*, *supra* note 38. To that end, we next discuss more normative approaches to in-house counsel responsibilities.

51. And of course in-house counsel’s answer might change as they learned both the extent and costs of non-compliance as the crisis developed.

52. It is important to correctly choose whom to report to within the client company; because secondary managers may be conflicted, *see supra* note 39 and accompanying text, in-house counsel can face a reporting-up problem, Steven L. Schwarcz, *The Role of Lawyers in the Global Financial Crisis*, 24 AUSTL. J. CORP. L. 214, 220 (2010) (observing that since the duties of corporate lawyers are to the organization as client under the *Model Rules of Professional Conduct*, rule 1.13, such lawyers should report to the senior managers and directors who are better incentivized to act on behalf of the company as a whole).

53. COFFEE, *supra* note 31, at 2. Reinier Kraakman developed the concept of gatekeepers by considering when liability should be imposed on third-parties who failed to prevent misconduct they could have disrupted by failing to cooperate with wrongdoers; usually by withholding specialized, professional services. *See generally* Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53 (1986).

54. COFFEE, *supra* note 31, at 2. In the legal services context, reputational effects are often considered less directly applicable to in-house counsel themselves than to the outside law firms that clients retain for transactions and other matters. *See* Steven L. Schwarcz, *To Make or to Buy: In-House Lawyering and Value Creation*, 33 J. CORP. L. 497, 510–12 (2008). Empirical data cast some doubt on this assumption, but are not definitive. *Id.* at 519–22.

party investors who rely on an assumption that companies act on the basis of quality professional advice to minimize their legal risk.⁵⁵ In-house counsel are specially equipped to fill this role by virtue of their access to information about the client and their familiarity with its organization and its business practices.⁵⁶ The gatekeeper role implies special responsibilities for corporate and in-house counsel beyond the zealous advocacy for one's client expected of litigators.⁵⁷

Judge E. Norman Veasey and Christine Di Guglielmo further argue for a "persuasive counselor" model,⁵⁸ in which lawyers, especially in-house counsel,⁵⁹ should "affirmatively, proactively, and *courageously* try to persuade their clients to follow the law, to go beyond mere compliance with the law, and even to 'do the right thing'

55. COFFEE, *supra* note 31, at 2–5. One scholar has recently developed a theory that raises questions about the efficacy of gatekeepers in some circumstances, arguing that financial transaction failures can result from a "multiple gatekeeper phenomenon." Andrew F. Tuch, *Multiple Gatekeepers*, 96 VA. L. REV. 1583, 1585 (2010) (introducing this term). Because of the multitude of professionals—he focuses on lawyers—involved in complex financial transactions, any given professional has an incentive to minimize his role. *Id.* at 1603; *see also* Bevis Longstreth, *Corporate Law: Problems in the Corporate Bar (As It Appears to a Retired Practitioner)*, MONT. LAW., Feb. 2006, at 22, 23 (discussing practitioners' tendency to narrow their vision "to avoid the difficulty of having to say 'no'" to a client); Milton C. Regan, Jr., *Teaching Enron*, 74 FORDHAM L. REV. 1139, 1166–72, 1231–32, 1246–48 (2005) (discussing lawyers hiding in the shadows of the divisions of responsibility). He also argues that the multiple gatekeeper phenomenon allows clients to position themselves between gatekeepers so that no party has complete knowledge of transactions. Tuch, *supra*, at 1603–04 (discussing the merger of Bank of America and Merrill Lynch as an illustration of this concern). Although that argument incongruously assumes that the companies themselves wish to court failure, it might have some explanatory power in a fraud. That argument, however, fails to resolve, at least in the context of legal gatekeepers, why in-house counsel do not fill the gap of outside counsel as gatekeepers. Indeed, in-house counsel should be positioned to see the totality of a transaction and prevent their corporate clients from exploiting gaps between gatekeepers. *See infra* notes 89–90 and accompanying text (discussing the need for in-house counsel to have full access to information about a client's business and transactions).

56. *See* COFFEE, *supra* note 31, at 195.

57. *See id.* at 193. Coffee recognizes difficulties in applying the gatekeeper role to attorneys, such as the inherently imprecise nature of legal opinions, conflicts with lawyers' advocacy role, and the possible chilling effect on attorney-client communications. John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 353 (2004). However, Coffee believes reform can overcome such barriers to make lawyers effective gatekeepers where warranted. *Id.* at 354–55.

58. E. Norman Veasey & Christine T. Di Guglielmo, *The Tensions, Stresses, and Professional Responsibilities of the Lawyer for the Corporation*, 62 BUS. LAW. 1, 30 (2006).

59. *See id.* at 29 (explaining that post-Enron concerns that lawyers were not effectively policing their business and accounting clients were directed at in-house corporate counsel in particular).

from a moral or ethical perspective.”⁶⁰ Similarly, Professor Robert Rosen argues that in-house counsel should “maintain and condition managerial discretion” while “convinc[ing] others about what is in their own and the corporate interest.”⁶¹ This model is consistent with added responsibility for in-house counsel based on their superior information and influence within an organization, but stops short of recognizing a special role for corporate lawyers in protecting the interests of third-party investors.⁶²

The gatekeeper and persuasive counselor models⁶³ establish potential normative frameworks in which to assess what in-house

60. Veasey & Di Guglielmo, *supra* note 58, at 30 (emphasis added). The idea that in-house counsel should act as “statesman adviser[s],” guiding their clients around legal problems and protecting the clients’ long-term interests, has deep roots in the American legal tradition, but truly came into its own after the Second World War. See Robert W. Gordon, *A New Role for Lawyers?: The Corporate Counsel after Enron*, 35 CONN. L. REV. 1185, 1207–09 (2003) (describing the history of the lawyer-as-counselor idea and advent of a theoretical underpinning for it by scholars such as “Lon Fuller, Willard Hurst, Hart and Sacks, and Beryl Harold Levy”).

61. Rosen, *supra* note 31, at 524. Rosen continues:

Practicing preventive law thus requires judgment about the corporate processes in which expectations about managerial actions are managed. It requires engaging managers, not as an executive with veto power, but as a manager among others. The practice of preventive law thus requires a willingness to alter one's own expectations and work in a process that the lawyer cannot control. Outside counsel are not employed because they cannot acquire the necessary convergent expectations and customize their work to match and develop corporate commitments to legal compliance as efficiently as inside counsel.

Id. (footnote omitted).

62. See *id.* at 524–27; see also Gordon, *supra* note 60, at 1211 (“The notion that the counselor’s role has to be consistent with the law’s public purposes . . . does not mean that she must become an informer or enforcement officer. . . . She is perfectly entitled to present an innovative view of the law and facts that favor what her client wants to do, so long as it is a view that she thinks a judge or other competent law-maker would actually be likely to accept.”). Gordon goes further than Veasey, Di Guglielmo, and Rosen by suggesting that “Independent Counselor[s]” be created to serve corporate clients under distinct ethical and professional responsibilities commensurate with their function. *Id.* at 1210. Professor Gordon’s intriguing suggestion is beyond the scope of this paper, but his description of the independent counselor’s role works quite well as an aspirational archetype for how “persuasive counselors” might practice within a company.

63. Interestingly, these theoretical constructions of the in-house counsel role are paralleled by sociological research carried out by Nelson & Nielsen, *supra* note 37. The authors surveyed a number of in-house counsel to determine how they constructed their own role within a company and from there constructed three “ideal types”: the “cop” (who primarily policies actors within the organization), the “counsel” (who mostly acts in an advisory capacity, blending business and legal advice), and the “entrepreneur” (who views legal advice as another source of potential value creation for the company). *Id.* at 462–68. While the overlap between the ideal types and the

counsel's standard of care should be. Gatekeepers, perceiving an obligation to the public beyond that to their client,⁶⁴ should scrutinize mortgage-securitization transactions not only for conformity with the legal obligations of their clients but also for the potential of legal failures to impact financial markets.⁶⁵ Persuasive counselors should affirmatively and proactively watch out for the client's interest.⁶⁶

Whichever overarching theoretical framework is applied, lawyers, including in-house counsel, in practice have to decide how to advise their clients on legal risk by exercising their professional judgment under conditions of uncertainty and in the face of multiple variables.⁶⁷ Under the gatekeeper model, counsel would have to exercise this judgment by taking into account not only their clients but also the public, including possible costs to financial markets. Any such exercise of judgment would necessarily be highly subjective.⁶⁸ To attempt to

theoretical frameworks is not perfect, *see id.* at 470–71, the similarities between the two sets of models is striking.

64. There is a long history of contentious debate surrounding the extent to which lawyers owe duties to the larger public; for a summary of this debate, *see* Steven L. Schwarcz, *The Limits of Lawyering: Legal Opinions in Structured Finance*, 84 TEX. L. REV. 1, 14–17 (2005). Where lawyers encounter intrinsically unlawful transactions, it is reasonable to suppose they have a duty to protect the public from the negative externalities that could result. *See id.* at 24–25. However, imposing broader duties to the public could force lawyers to second-guess the business decisions of their clients; a role for which they generally lack adequate information and training. *See id.* at 29. Although in-house counsel might be better-positioned to make these judgments given their knowledge of the client company, creating dual obligations for in-house counsel would still likely create inefficiencies and allow lawyers to use ill-defined duties to “pursue their own ideological goals in favor of client interests.” Sean J. Griffith, *Afterward and Comment: Towards an Ethical Duty to Market Investors*, 35 CONN. L. REV. 1223, 1234 n.43 (2003).

65. *See* Coffee, *supra* note 57, at 360–61 (explaining that what sets attorneys as gatekeepers apart from advocates are “(1) a need for greater independence from the client; (2) a recognition of a duty to the public; and (3) professional skepticism”).

66. One observer even suggests that American in-house counsel, in particular, tend to be more proactive as a result of their emergence from a culture that encourages entrepreneurialism, that values lawyers as business, political, and civic leaders, and that makes use of a distinctive adversarial legal system. Mary C. Daly, *The Cultural, Ethical, and Legal Challenges in Lawyering for a Global Organization: The Role of the General Counsel*, 46 EMORY L.J. 1057, 1068–78 (1997).

67. *See* Jonathan T. Molot, *A Market in Litigation Risk*, 76 U. CHI. L. REV. 367, 368–69 (2009) (describing law practice as, in part, an exercise in “risk management” rather than an exact, predictive science).

68. One of us thus observes that, in practice, because in-house counsel's direct responsibility to the public is limited to that imposed by law and the rules of ethics, it might be useful to begin thinking of this wider obligation as indirect: counsel has, of course, a direct fiduciary obligation to their corporate client, but that client also has responsibilities to the public to comply with the law and even to be a good “corporate citizen.” In-house counsel's role, then, includes a fiduciary obligation to help the corporation define as well as fulfill those responsibilities. Kathleen Cully,

provide some guidance, Professor Richard Gruner, a former in-house counsel for IBM, proposes factors that in-house counsel should consider in determining how much information their corporate clients need to make an informed decision on a legal issue.⁶⁹ These factors include the “diversity [i.e., multitude⁷⁰] of parties” implicated in a legal issue, the specific nature and scope of the legal requirements faced by the corporate actor, and the “duration of the . . . impact” of the corporate decision.⁷¹

Consider how the gatekeeper and persuasive counselor models, as informed by Gruner’s factors, could inform the mortgage-note controversy. The first question is whether in-house counsel, even under those models, should or even could have foreseen the mortgage-note controversy. Business managers face substantial time and information constraints in their decision-making; therefore their legal information needs increase with the amount of legal uncertainty and risk entailed in a given decision.⁷² But it is doubtful that in-house counsel could have foreseen the mortgage-note controversy or should have recognized the

Statement at University of Wisconsin Law Review Symposium: Who’s in the House? The Changing Role and Nature of In-House and General Counsel (Nov. 18, 2011).

69. Richard Gruner, *Improving the Effectiveness of Corporate Counsel: An Information Processing Analysis*, 9 J. CORP. L. 217, 228–29 (1984). This framework is one way to conceptualize the cost-benefit analysis faced by in-house counsel, but there are other methods that could be employed to weigh the probability and magnitude of legal risk. In the litigation context, models analyzing the trade-offs faced by litigants have employed traditional cost-benefit techniques with discounted cash flow analysis, *see, e.g.*, John P. Gould, *The Economics of Legal Conflicts*, 2 J. LEGAL STUD. 279 (1973); Steven Shavell, *Suit Settlement, and Trial: A Theoretical Analysis under Alternative Methods for the Allocation of Legal Costs*, 11 J. LEGAL STUD. 55 (1982), game-theoretic models, *see, e.g.*, Lucian Arye Bebchuk, *Litigation and Settlement under Imperfect Information*, 15 RAND J. ECON. 404 (1984); I. P. L. P’ng, *Strategic Behavior in Suit, Settlement, and Trial*, 14 BELL J. ECON. 539 (1983), and real options pricing models, *see, e.g.*, Bradford Cornell, *The Incentive to Sue: An Option-Pricing Approach*, 19 J. LEGAL STUD. 173 (1990); Joseph A. Grundfest & Peter H. Huang, *The Unexpected Value of Litigation: A Real Options Perspective*, 58 STAN. L. REV. 1267 (2006).

70. Gruner, *supra* note 69, at 228 (explaining that legal risk increases with the number and variety of parties affected by a company’s decision since each represents a potential source of liability).

71. *Id.* at 228–29.

72. *Id.* at 229.

When these factors cause uncertainty about legal restrictions to be high, corporate decision makers must either obtain the information necessary to reduce their legal uncertainty, or accept the substantial risk that a chosen course of action will not comply with legal requirements. The greater the legal uncertainty associated with a particular decision, the more information that must be processed to allow the decision to be made in a legally prudent manner.

Id.

alleged legal uncertainty at the heart of the controversy. Mortgage-securitization transactions were long considered standard, low-risk financial transactions⁷³ and would not, by themselves, have raised inferences of legal uncertainty or risk. And the structural risk was further reduced in 2001, when the UCC was amended to make it clear that the sale of promissory notes could be effected merely by the seller signing a sale agreement describing the notes.⁷⁴

Even though compliance with the delivery instructions would increase the SPV's level of protection against possible third parties who might gain possession of the notes and would also facilitate enforcement of the notes,⁷⁵ the decision as to when, and whether, to enforce the delivery instructions reflects a business risk. In-house counsel would perform even their normative duties under these models by notifying the client of the reasonably foreseeable consequences of non-possession. The fact that compliance with the delivery instructions would be needed to enforce the notes should not have been problematic; such instructions could later be complied with as to notes that need to be enforced. Thus, even if one assumes that in-house counsel are responsible for post-hoc monitoring of transactions after the closing,⁷⁶ the fact that the delivery instructions were not initially complied with would not necessarily have been a red flag signaling wrongdoing or error.⁷⁷

The second question assumes in-house counsel could have foreseen the possibility of the mortgage-note controversy and asks what in-house counsel should have done about it. Although mortgage-securitization transactions were of relatively long duration and were engaged in by a multitude of parties with large amounts of money at stake, there seemed to be little or no litigation risk because the transactions appeared to be (and indeed likely were) in compliance with applicable law. Any litigation that might subsequently be commenced would therefore likely be viewed, at that time, as extremely unlikely to succeed. There remains, however, a question as to whether in-house counsel should have anticipated the extent to which the mortgage-note controversy might become a matter of public interest or be politicized.

73. Daniel J. McDonald & Daniel L. Thornton, *A Primer on the Mortgage Market and Mortgage Finance*, FED. RES. BANK ST. LOUIS REV., Jan./Feb. 2008, at 31, 36.

74. See *supra* notes 16-19 and accompanying text.

75. See *supra* notes 21-22 and accompanying text.

76. For a discussion of whether in-house counsel should be responsible for post-hoc monitoring, see *infra* notes 85-87 and accompanying text.

77. Indeed, it appears that, in at least some mortgage-securitization transactions, the notes may *not* have been physically delivered. See *supra* note 14.

In answering this question, it is important to recognize that the vast majority of mortgage-securitization transactions were executed prior to housing prices plummeting in late 2007.⁷⁸ Only thereafter did the trickle of mortgage-related lawsuits become a torrent and mortgage-securitization transactions suffer billions of dollars in losses,⁷⁹ creating a much more serious problem.⁸⁰ Prior to that dramatic shift in the financial and political landscape, the specter of claims based on the failure to physically deliver mortgage notes might well have been judged chimerical. Likewise, the idea that such claims would gain substantial political traction and prompt a public controversy that would itself drain a client's goodwill and resources would have appeared highly unlikely.⁸¹

It therefore appears, even under the gatekeeper and persuasive counselor models as informed by Gruner's factors, that in the unlikely event in-house counsel had foreseen the possibility of the mortgage-note controversy, such counsel should have had no duty to do anything about it other than perhaps to include that possibility when informing the client of possible consequences of non-possession. An in-house counsel might also have decided to alert the client to the possibility, albeit remote, that arguments might be politicized. Even breach of a mere technicality can engender strategic litigation under the right circumstances,⁸² and "early interception of . . . [a problem] is much

78. See FED. HOUS. FIN. AGENCY, HOUSING AND MORTGAGE MARKETS IN 2010, at 36 (2011), available at <http://www.fhfa.gov/webfiles/21846/MMErevised81011.pdf> (observing that private-label MBS issuance peaked in 2005 at about \$1.2 trillion while issuance in 2010 was only about \$60 billion, with similarly diminished quantities issued in 2008 and 2009).

79. See, e.g., Kerry E. Grace, *Moody's Raises Estimate for Subprime Losses*, WALL ST. J., Feb. 27, 2009, at C3; Yalman Onaran, *Banks' Subprime Losses Top \$500 Billion on Writedowns*, BLOOMBERG (Aug. 12, 2008), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a8sW0n1Cs1tY&refer=home>.

80. Monica Pinciak-Madden & Katya Jestin, *Subprime Crisis: The Unraveling Promises to Increase the Number of Civil Suits and Criminal Investigations*, N.Y. L.J., Jan. 5, 2009, available at http://www.jenner.com/system/assets/assets/2527/original/NYLJ_Jestin_Pinciak_Madden.pdf?1319122463 (noting that more than half of the 800 subprime-related lawsuits initiated since 2006 were filed in 2008).

81. This paragraph notes an important distinction between the foreseeability of a possible legal argument by claimants and an economic and political environment in which such claims might be more enduring. Whether and to what extent in-house counsel are equipped to forecast the "social, economic, and political factors" that impact different areas of law, as some suggest they should, Liggio, *supra* note 43, at 1209, is an open question. Certainly the skills required to make such predictions are not usually part of the typical training and education of contemporary lawyers.

82. See Steven L. Schwarcz, *Explaining the Value of Transactional Lawyering*, 12 STAN. J.L. BUS. & FIN. 486, 496-97 (2007) (citing survey and anecdotal evidence supporting the assertion that money disputes frequently lead to litigation,

easier than cleaning up a mess after the fact”⁸³—a mess that increasingly includes reputational harm.⁸⁴ Although there are few objective standards to determine, in the abstract, what conduct makes a “great” as opposed to a merely “competent” attorney, lawyers, including in-house counsel, ideally should strive to serve their clients in a manner that exceeds the metes and bounds of their bare obligations.

Consider next, more generally, the extent to which in-house counsel should be responsible for post hoc monitoring of transactions after the closing. In-house counsel have limited time and resources to bring to bear on problems,⁸⁵ so they naturally should focus on the more important problems that their skills and expertise can help resolve. Unless in-house lawyers had reason to believe that delivery instructions were inappropriately not being followed,⁸⁶ monitoring the transfer of assets sold after an agreement was entered into would not be among their priorities. Nor should it have been, given the standardized nature of the transactions involved.⁸⁷

In-house counsel should be entitled to presume, absent becoming aware of evidence suggesting otherwise, that their clients will act rationally. Any other approach would not only be inefficient but would risk putting counsel into an adversarial relationship with the client.

D. What, If Anything, Could In-house Counsel Have Done to Mitigate the Mortgage-Note Controversy?

We next consider what in-house counsel of clients structuring or investing in mortgage-securitization transactions could have done to mitigate some of the impact of the mortgage-note controversy, once that controversy became apparent. To what extent, for example, could in-house counsel have acted aggressively to identify possible hostile legal claims and to offer competing narratives to contrast with the mortgage-fraud account that helped generate the underlying controversy?

In-house counsel could have done a lot to mitigate the controversy. In-house counsel generally have access to information about their

regardless of contract terms, and that a key responsibility of lawyers as contract drafters is to provide a roadmap for parties to follow in a dispute).

83. Hazard, *supra* note 43, at 1021.

84. Simmons & Dinnage, *supra* note 31, at 128, 139–40.

85. Nelson & Nielsen, *supra* note 37, at 472 (explaining that in-house counsel surveyed in their study frequently operate under the dual constraints of limited resources and profit pressures).

86. See MODEL RULES OF PROF'L CONDUCT R. 1.13(b) (2011).

87. U.C.C. § 9-203(b)(3)(A) (1998). For a discussion of what steps in-house counsel could have taken to mitigate the mortgage-note controversy, once they learned of it, see *infra* Part III.D.

client's contracts, business operations, and compliance documents, especially if such counsel cultivates a good working relationship with senior executives.⁸⁸

Better policies and procedures might have helped to mitigate the mortgage-note controversy. Survey data from before and after the 2008 financial crisis suggest that many corporate directors believed their companies either lacked risk-management programs or doubted the efficacy of systems that were in place.⁸⁹ In-house counsel might have been able to offer more systematic guidelines for future MBS contract performance and compliance, clarifying the options. Any such guidelines would need to carefully instruct the operational employees to avoid the risk that old procedures would continue to be followed or that new procedures would be adopted for old transactions. In-house counsel should also avoid drafting guidelines that might be argued to constitute recognition of errors under prior procedures.⁹⁰

These guidelines might have featured management education, internal reports, and protocols for investigation.⁹¹ In crafting the guidelines, in-house counsel need not act alone. Industry associations and outside counsel are valuable sources of specialized expertise that in-house counsel can draw on in crafting a compliance system. For instance, the Securities Industry and Financial Markets Association (SIFMA) and the American Securitization Forum publish a variety of guidelines and best practices that offer useful foundations for compliance programs.⁹² In industries like real estate securitization where actors face similar risks and use similar business models,

88. See Simmons & Dinnage, *supra* note 31, at 113 (suggesting that in-house counsel "should have the opportunity to be part of the management team").

89. Stephen M. Bainbridge, *Caremark and Enterprise Risk Management*, 34 J. CORP. L. 967, 970–71 (2009) (referencing a pre-crisis survey indicating forty-three percent of respondents doubted the effectiveness of risk mitigation strategies or had not implemented them and also a 2008 survey in which more than seventy percent of respondents were concerned about their companies' approach to risk management.)

90. The best-case scenario for MBS issuers would have been to redraft standard PSAs immediately after the 2001 revision of Article 9 of the UCC since this would justify a change in delivery instructions as merely aligning them with the redrafted code.

91. See Simmons & Dinnage, *supra* note 31, at 118.

92. *Housing Finance and Securitization Resource Center*, SIFMA, <http://www.sifma.org/issues/capital-markets/securitization/housing-finance-and-securitization/resources/> (last visited Oct. 2, 2011); *Market Standards & Practices*, AM. SECURITIZATION F., <http://www.americansecuritization.com/hub.aspx?catid=19&mainid=5> (last visited Oct. 2, 2011).

external coordination can ease the burden on in-house counsel seeking to establish a compliance regime for their client-company.⁹³

After establishing guidelines, in-house counsel could have built a system for monitoring compliance. Monitoring efforts would necessarily have been constrained by the limited time and resources of in-house counsel.⁹⁴ Nonetheless, a monthly spot-check of some representative transactions may well have been prudent.

Of course, even the best compliance program will be of limited effectiveness if the client's employees are ignorant of its major components.⁹⁵ In-house counsel could have designed and implemented internal management training programs. Effective compliance education can also include non-legal staff in order to offset the limited resources of in-house legal departments.⁹⁶

When faced with an unexpected legal challenge outside their routine practice, in-house counsel often find it efficient to turn to outside lawyers for assistance.⁹⁷ Confronted with the mortgage-note controversy, in-house counsel therefore could have retained outside counsel to help assess the strengths of potential claims and reputational damage, and to consider appropriate legal responses.⁹⁸ Outside counsel would be especially helpful if, for example, management conflicts were part of the reason for lapses leading to the controversy.⁹⁹ Perhaps also

93. Chayes & Chayes, *supra* note 31, at 285–86 (noting that a “programmatic approach” to preventing legal problems is well-suited to repetitive transactions such as financings).

94. See *supra* note 85 and accompanying text.

95. Chayes & Chayes, *supra* note 31, at 284.

96. *Id.* at 286.

97. *Id.* at 289–90; see also Schwarcz, *supra* note 54, at 507 (discussing the economies of scale offered by outside counsel when a company engages in non-standard or particularly large transactions). Outside counsel can also help by increasing objectivity. Cf. DeMott, *supra* note 43, at 968–69 (questioning the ability of in-house counsel to objectively assess policies and decisions they participated in making).

98. See Schwarcz, *supra* note 54, at 507 (discussing the economies of scale offered by outside counsel when a client company engages in non-standard or particularly large transactions). In-house counsel's supervision of the outside lawyers auditing the client-firm would have to be strictly limited in scope since an audit would almost certainly implicate some decisions made by in-house counsel themselves. See DeMott, *supra* note 43, at 972. Where a potential conflict exists between in-house and outside counsel, the latter should fully investigate the question autonomously before revealing their findings to the client and its in-house legal team. However, absent indications of outright fraud or illegality, such conflicts pose less of a problem, and coordination between in-house and outside counsel auditing mortgage securitization firms would likely have been helpful, on balance.

99. Cf. Sally R. Weaver, *Ethical Dilemmas of Corporate Counsel: A Structural and Contextual Analysis*, 46 EMORY L.J. 1023, 1045 (1997) (suggesting in-house counsel look to outside representation where there is a potential conflict between management and the interests of the company).

with the help of outside counsel, in-house counsel could have reviewed their client's mortgage-securitization transactions to look for any irregularities.

Finally, in-house counsel could have been more aggressive in publicly countering the claims of critics who alleged that certain mortgage-securitization transactions were illegitimate. To a large extent, the mortgage-note controversy is a product of the economic and political climate produced by the 2008 financial crisis. In-house counsel could have offered a narrative different than mortgage fraud to help shape the context in which claims against their clients would be considered.¹⁰⁰ Accurate information is critical because:

[The media] will hop on anything. And the people who are assigned are . . . not financial journalists. So many of them don't have a background and don't really frankly know what it is they're writing about. They don't really frankly understand those stories that they are writing, and they get things wrong very frequently; like very, *very* frequently . . . and maybe not wrong enough that it has to be retracted, but wrong enough that it creates a misleading impression, sometimes on purpose and sometimes by accident.¹⁰¹

To this end, it is becoming increasingly routine for in-house counsel to large companies, in coordination with management, to help develop talking points, press releases, and, more broadly, a strategy for engaging with critics in the media.¹⁰²

In helping to shape the public narrative, in-house counsel must often share privileged and confidential information with public-relations staff and even outside consultants.¹⁰³ Communications with outsiders should be treated carefully because the privileged status of information

100. Michele DeStefano Beardslee, *Advocacy in the Court of Public Opinion, Installment One: Broadening the Role of Corporate Attorneys*, 22 GEO. J. LEGAL ETHICS 1259, 1270–73 (2009) (examining how public discussion can impact future claims and regulatory actions). Beardslee surveyed and interviewed a number of general counsel to S&P 500 companies as well as public-relations professionals to gain insight into how in-house counsel help to shape the public image of their client companies. *Id.* at 1264–65.

101. *Id.* at 1280–81 (quoting Interview by Michelle Stefano Beardslee, with #2, General Counsel, Investment Bank (Feb. 4, 2008), at 13) (articulating a common refrain among corporate counsel and public-relations professionals).

102. *Id.* at 1295.

103. *Id.* at 1289–90.

is sometimes uncertain and highly context-dependent.¹⁰⁴ Similarly, documents produced in collaboration with outside consultants might not be subject to work-product protection, even when such documents discuss possible claims against the client company.¹⁰⁵ In-house counsel should also carefully monitor public statements to avoid disclosing details of pending or potential legal claims and to ensure that any public commentary is grounded in good faith legal analysis.

It should not be beyond the scope of in-house counsels' role to occasionally represent a client's view to the public, so long as in-house counsel first vets that view with the client. In-house counsel also could coordinate with industry or trade groups that can act as surrogates in public discourse, in order to put forth arguments that such counsel or their clients might not feel comfortable making individually.¹⁰⁶

CONCLUSION

Analyzing in-house counsel's role and responsibility in light of the mortgage-note controversy reveals the constraints under which in-house lawyers work while managing legal risk for their clients. Although in-house counsel are dedicated to a single client-company, are strategically positioned to understand the full scope of that company's operations, and are privy to superior networks of information—all of which allow them to act preventively—there are some issues that cannot be foreseen. Novel claims of questionable merit, like the A-B-C-D theory we assess above, are likely beyond the ambit of even skilled attorneys. Even if one assumes a high aspirational standard of care like that encompassed in the gatekeeper model,¹⁰⁷ in-house counsel probably could not have

104. See Ann M. Murphy, *Spin Control and the High-Profile Client—Should the Attorney-Client Privilege Extend to Communications with Public Relations Consultants?*, 55 SYRACUSE L. REV. 545, 570–78 (2005).

105. See Michele DeStefano Beardslee, *Taking the Business out of Work Product*, 79 FORDHAM L. REV. 1869, 1929 (2011).

106. See, e.g., SEC. INDUS. & FIN. MKTS. ASS'N, SIFMA Q&A REGARDING MORTGAGE LOAN TRANSFERS AND SECURITIZATION (2010), available at http://www.sifma.org/uploadedfiles/issues/capital_markets/securitization/securitization/sifma%20mortgage%20transfer%20and%20securitization%20question%20and%20answers.pdf.

107. In this context, it is also important to bear in mind that in-house counsel are also in a uniquely difficult position. They are lawyers with only a single client and should they be terminated by that client, they would likely find it extremely difficult to obtain a new legal position. Cf. *In re Oracle Securities Litigation*, 829 F. Supp. 1176, 1189 (1993) (discussing the perceived conflict between a general counsel's duty to a client corporation's shareholders and his financial dependence on the company's directors). In addition, courts are generally unwilling to provide legal recourse to lawyers terminated for "whistleblowing" and other conduct mandated by ethical rules, on the basis that such conduct is expected of all lawyers. See Weaver, *supra* note 99, at

predicted the mortgage-note controversy before the financial crisis and, accordingly, could not have been expected to warn clients about potential claims therefrom.

More generally, in-house counsel work within budgetary and time constraints, coupled with political realities. The role of in-house counsel in particular circumstances is thus tempered by reality, taking into account such factors as views of then-probable future events, consequences, costs, internal dynamics, and personalities. This can only be done case by case, guided of course by rules of ethics and law.

Subject to these constraints, in-house counsel not only help to shape the corporate client's policies to the public but also help the client to meet its business targets while complying with law. Weighing these competing and often incommensurable goals and strategies is extremely challenging, especially given the likelihood that the actions of in-house counsel will largely be judged in hindsight by people emphasizing success over legal "technicalities" with which they are not familiar.

1028–29. Thus, in-house lawyers' unique and strategic position serving a single client also operates as a practical constraint on their ability to act preventively by policing the client company.

